Internal Revenue Service

memorandum

date: AUG 12 1991

to: District Counsel
Honolulu, Hawaii
Attn: Carol Muranaka

from: Assistant Chief Counsel CC:P&SI
(Passthroughs and Special Industries)

subject: [redacted]
TR-45-508-91

This is in response to your memorandum dated April 1, 1991, and subsequent correspondence concerning the application of the investment credit transitional rules to a transaction entered into by the above-named taxpayer. The facts of that transaction, as submitted, are as follows.

On [redacted], [redacted] entered into five related agreements titled: 1) Equipment Lease Agreement; 2) Participation Agreement; 3) Tax Indemnity Agreement; 4) Security Agreement; and 5) Agency Agreement. Pursuant to these agreements certain [redacted] testing equipment with a cost basis of $[redacted], was purchased by [redacted] and leased to the [redacted]. [redacted] simultaneously subleased the equipment to [redacted] who, pursuant to the Agency Agreement, purchased the equipment on behalf of [redacted].

[redacted] purchased $[redacted] of the equipment after the January 1, 1986, effective date for the repeal of the regular percentage investment credit as provided in former section 49(a) of the Internal Revenue Code. Accordingly, for the property to qualify for the credit (and ACRS), it must meet the definition of transition property in former section 49(e). You have requested our views as to whether the above specified agreements entitle the taxpayer to transition relief.

Former section 49(e)(1) of the Code defined the term "transition property" as any property placed in service after December 31, 1985, and to which the amendments made by section 201 (which modified the accelerated cost recovery system) of the Tax Reform Act of 1986 do not apply, except that in making the determination section 203(a)(1)(A) of the Act shall be applied by substituting "1985" for "1986", and sections 203(b)(1) and

204(a)(3) of the Act shall be applied by substituting "December 31, 1985", for "March 1, 1986." In addition, certain placed in service dates apply depending upon the class life of the transition property.

Section 203(b)(1)(A) of the Act provides the general transitional rule, commonly referred to as the "binding contract" rule. Pursuant to that rule, investment credit transition relief is afforded to any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written binding contract that was binding on December 31, 1985. The Conference Committee Report for the Act, 2 H.R. Rep. No. 99-841 (Cong. Rep.), 99th Cong., 2d Sess. II-54, 1986-3 (Vol. 4) C.B. 54, explaining the general binding contract transitional rule provides, in part, that the repeal of the investment credit and modification of ACRS does not apply to property subject to binding contracts, but that the rule "applies only into contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract." Further, a contract is binding only if its enforceable under State law against the taxpayer, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). [Conf. Rep. at II-55.]

The Conference Report further provides that for purpose of the general binding contract rule, a contract under which the taxpayer is granted an option to acquire property is not to be treated as a binding contract to acquire the underlying property. In contrast, a contract under which the taxpayer grants an irrevocable put (i.e., an option to sell) to another taxpayer is treated as a binding contract, as the grantor of such an option does not have the ability to unilaterally rescind the commitment. In general, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor. [Conf. Rep. at II-55.]

Lastly, the Conference Report states that the general binding contract rule does not apply to supply agreements with manufacturers, where such contracts fail to specify the amount or design specifications of property to be purchased; such contracts are not to be treated as binding contracts until purchase orders are actually placed.

In this situation, the "written binding contract", if one exists, is to be found in the Agreement to Lease, and surrounding documents. However, because the construction, reconstruction, erection, or acquisition of the property ([redacted] testing

equipment) is not itself the subject matter of the contract, the property does not qualify under the general binding contract rule.

Section 204(a)(3) of the Act provides, however, an additional transitional rule for property that is readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, that was binding on December 31, 1985. The conference report explaining this provision provides, in part, that:

> [t]he bill provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before March 2, 1986, (January 1, 1986, in the case of the investment tax credit). An example of a case to which this rule would apply would be lease agreements under which a grantor trust is obligated to provide property under a finance lease (to the extent continued under this bill)...

This transitional rule is applicable only where the specifications and amount of property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract .... [Conf. Rep. at 59-60]

In our opinion, [redacted]'s Agreement to Lease and accompanying documents do not satisfy the requirements of the transitional rule in section 203(a)(3) of the Act. Accordingly, the property placed in Service after December 31, 1985, is not eligible for transition relief. Our opinion is based on two factors: 1) the contract is not a binding contract within the meaning of the transitional rules; and 2) the specifications and amount of property are not readily ascertainable from the documents.

The purpose of the transitional rules is to provide relief to taxpayers that have prior to the effective dates irrevocably (or at least not without liability for damages) entered into agreements to acquire property with the expectation of certain tax benefits. In the context of the general binding contract transitional rule, X would have entered into a contract with Y to purchase property Z. Failure of either party to perform would subject the nonperforming party to damages. Hence, because the

contract is binding on the taxpayer that will acquire the property, transition relief is afforded.

In the context of the agreement to lease transitional rule in section 204(a)(3) of the Act, we believe the lease (or accompanying documents) must contain an explicit description of the property subject to the lease, and should as well spell out the term and rental payments. For example, X agrees to lease a Boeing 747 airplane for a period of years to Y at $z per year. Even though X has not purchased or placed in service the airplane by December 31, 1985, transition relief is granted because X is committed to provide the airplane and Y is committed to pay rent. Failure to perform by either party will result in liability for damages against the nonperforming party.

In the present situation, [redacted] has agreed to lease up to $[redacted] of "typical equipment" from "typical manufacturers". The sublessee, [redacted], as ultimate user of the property will also actually purchase the property pursuant to the Agency Agreement. We can discern nothing from the documents submitted that binds the lessee or sublessee to designate any property to be subject to the lease. In fact, although the lease provides for $[redacted] worth of equipment, less than $[redacted] has been leased. Further, we can discern no potential liability of the lessee or sublessee if they had failed to designate any property to come under the lease. Whether or not any property will in fact be subject to the lease agreement appears to be solely in the hands of the user of the property, [redacted]

In our opinion, [redacted], as sublessee and agent for the lessor merely holds an option to lease certain property necessary for its business. [redacted] (and the participants), on the other hand, has merely extended a line of credit to facilitate the purchase of any equipment that the sublessee opts to purchase. As such, we do not believe this is the type of binding contract that Congress intended to grandfather, as it does not subject all parties to potential liability for breech, and it is subject to a condition within the control of one of the parties (i.e., [redacted]'s sole decision to purchase property under the Agency Agreement).

Further, the Lease Agreement and the accompanying documents fail to describe the specifications and amount of property that is subject to the lease. Rather, a schedule is attached to the agreement that merely lists "typical equipment" and "typical manufacturers" without specifying how many of each listed item of equipment will be obtained. We presume that because of this uncertainty precise rental payments are not listed, as it was not

clear when the documents were executed just what equipment would be leased. Because the specifications and amount of property are not clearly ascertainable nor readily identifiable with the agreement to lease, this aspect of the transitional rule is also not met.

There is some support for the taxpayer's position in the committee report's example of the put option noted above. That is, because the decision is outside of the [redacted]'s control whether he will be forced to acquire the property by the holder of the put, the committee report provides that the property is eligible for transition relief. Similarly, because the decision to purchase any property to be subject to the lease is in the sole discretion of [redacted], [redacted] can argue that its situation is analogous to the put transaction. While this argument is not without merit, we do not think is sufficient to overcome the deficiencies in meeting the transitional rules noted earlier. In addition, this transaction is not in fact a true put option, and it was only a true put option the committee reports addressed. Further, in the put option transaction the taxpayer has received a payment in exchange for risking the exposure that it might have to purchase the property subject to the put, which is not present in [redacted]'s case. Further, the put contract will specifically describe both the property and the price at which the property will be sold, neither of which are present in the instant case. Accordingly, we do not believe the analogy to the put contract is of sufficient weight to overcome the previously mentioned reasons for denying transition relief.

The only other guidance on section 204(a)(3) of the Act concerns the supply or service contract aspect of the transitional rule. Specifically, there is a colloquy in the Senate which discusses application of that rule to "power purchase agreements." In the colloquy among Senators Matsunaga, Packwood, and Long, Senators Packwood and Long confirm that the supply or service contract rule is intended to cover "a taxpayer who entered into a written, binding power sales contract by the qualification date and is required to construct or have constructed facilities that will produce the power necessary to fulfill this contractual obligation." 132 Cong. Rec. S8241 (daily ed. June 24, 1986). In the same colloquy, Senators Packwood and Long also confirm Senator's Matsunaga's understanding that the requirement that the specifications and amount of property be readily ascertainable from the terms of the contract is met "when a binding power purchase contract specifies the type of generating equipment in terms of primary energy source and specifies the amount of generating equipment in terms of total generating capacity of the turbines necessary to produce

the contracted power[.] In other words, the rule does not require the technical details of the generating property to be spelled out." Id. We have issued several letter rulings on this transitional rule for power purchase agreements where only the source of power (for example, orchard prunings) and the capacity (for example, 50 megawatts), as well as location, were specifically spelled out in the contracts. That is, even though there was not a delineation of the types and amounts of equipment to be used in the plant, it appears that Congress nevertheless desired to grandfather these plants based on the meager language in the conference report and the colloquies, and we have so ruled.

Although the service and supply contract and agreement to lease are in the same transitional rule, there is no indication that the agreement to lease should be interpreted the same way as the power purchase contracts. Further, transactions involving utilities have always been subject to special rules, primarily because of the regulatory environment in which they operate. Utilities are different from other taxpayers and any analogy to rules designed solely for them is tenuous at best. Accordingly, we do not believe that the rulings concerning power purchase agreements assist the taxpayer and should not inhibit our decision in the instant case that transition relief is unwarranted. Transitional rules, being deviations from the normal rules, should be strictly construed.

We hope the foregoing will provide you with the assistance you desire. Should you have any questions or wish to discuss this matter further, please contact Patrick McGroarty of this office at FTS 377-6349.

PAUL F. KUGLER
Assistant Chief Counsel

By: (signed) James F. Ranson
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